

**PUBLIC UTILITIES COMMISSION**

505 VAN NESS AVENUE

SAN FRANCISCO, CA 94102-3298

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August 5, 2019

Agenda ID #17628  
Ratesetting

## TO PARTIES OF RECORD IN APPLICATION 18-04-025:

This is the proposed decision of Administrative Law Judge Karl J. Bemederfer. Until and unless the Commission hears the item and votes to approve it, the proposed decision has no legal effect. This item may be heard, at the earliest, at the Commission's September 12, 2019 Business Meeting. To confirm when the item will be heard, please see the Business Meeting agenda, which is posted on the Commission's website 10 days before each Business Meeting.

Parties of record may file comments on the proposed decision as provided in Rule 14.3 of the Commission's Rules of Practice and Procedure.

The Commission may hold a Ratesetting Deliberative Meeting to consider this item in closed session in advance of the Business Meeting at which the item will be heard. In such event, notice of the Ratesetting Deliberative Meeting will appear in the Daily Calendar, which is posted on the Commission's website. If a Ratesetting Deliberative Meeting is scheduled, ex parte communications are prohibited pursuant to Rule 8.3(c)(4)(B).

/s/ ANNE E. SIMON

Anne E. Simon

Chief Administrative Law Judge

AES:lil

Attachment

Decision **PROPOSED DECISION OF ALJ BEMESDERFER** (Mailed 8/5/2019)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Application of California-American Water Company (U210W), Hillview Water Company, Inc. (U194W), Roger Forrester, and Jerry L. Moore and Diane F Moore, as trustees of the Jerry Moore and Diane Moore Family Trust, for an Order Authorizing the Sale of all Shares of Hillview Water Company, Inc. to California-American Water Company and Approval of Related Matters.

Application 18-04-025

**DECISION APPROVING PURCHASE OF WATER SYSTEM****Summary**

We approve the purchase of the Hillview Water Company, Inc. by California American Water Company for a total purchase price of \$7,470,459. We set the rate base of the acquired system at \$6,500,000 and permit recovery over a period of forty years of the difference of \$970,459 and on an allowance for deferred taxes of \$2,014,575, reflecting a tax liability created by the purchase.

**1. Background****1.1. Parties**

California American Water Company (Cal-Am) is a California corporation and it is a subsidiary of American Water Works Company, the largest publicly traded water utility in the United States, with operations serving approximately

16 million people in North America. Cal-Am is a Class A public water utility company currently serving approximately 630,000 customers in 50 communities.

Hillview Water Company, Inc. (Hillview) is a Class C Commission-regulated water utility serving approximately 1,500 connections spread over four sub-systems in the Sierra foothills in Madera County, California.

### **1.2. Procedural History**

On April 25, 2018, Cal-Am, Hillview and Hillview's owners (Joint Applicants) filed their initial joint application in this proceeding. The California Public Advocates Office (Cal Advocates) filed its Protest on June 4, 2018. Joint Applicants replied to the Protest on June 14, 2018. On July 16, 2018 the original Scoping Memorandum was issued in this proceeding. On October 3, 2018, Joint Applicants filed a Motion to Shorten Time and Stay Current Dates. On October 3, 2018, Joint Applicants also filed a motion to change the Scoping Memo to provide for a revised schedule as well as application corrections. Cal Advocates filed a response arguing the Commission should not permit Joint Applicants to file an amended application and should instead require they dismiss this proceeding and file a new application. An Amended Scoping Memo was issued on March 19, 2019 granting the motion to file an amended application and setting a new timetable for the proceeding. Pursuant to the Amended Scoping Memo, Joint Applicants filed an Amended Application on April 2, 2019. Evidentiary hearings were held on May 15 and 16, 2019. Opening briefs were filed on May 13, 2019 and reply briefs on June 21, 2019, at which time the matter was deemed submitted.

### **2. Issues Before the Commission**

The principal issues raised by the Amended Application are:

- (i) what is the fair market value of the Hillview Water Company?
- (ii) what amount shall be included in Cal-Am's rate base?
- (iii) may Cal-Am recover the federal income tax liability triggered by the increase in Hillview's equity resulting from the transaction and, if so, over what period?

We discuss other subsidiary issues in the course of addressing these principal questions.

### **3. Discussion and Analysis**

#### **3.1. Determination of Fair Market Value**

Public Utilities (Pub. Util.) Code Section 2720(a)(2) states:

For purposes of this section, "fair market value" shall have the same meaning as set forth in Section 1263.320 of the Code of Civil Procedure.

Section 1263.320 provides two options for determining fair market value:

- (a) The fair market value of the property taken is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.
- (b) The fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable.

One alternative method of valuation that is "just and equitable" is provided by Pub. Util. Code Section 2720, which deals specifically with the valuation of public water systems acquired by water corporations:

- a. The commission shall use the standard of fair market value when establishing the rate base value for the distribution

system of a public water system acquired by a water corporation. This standard shall be used for ratesetting.

1. [omitted]
  2. For purposes of this section, "fair market value" shall have the same meaning as set forth in section 1263.320 of the Code of Civil Procedure.
- b. (b) If the fair market value exceeds reproduction cost as determined in accordance with Evidence Code Section 820, the commission may include the difference in the rate base for ratemaking purposes if it finds that the additional amounts are fair and reasonable. In determining whether the additional amounts are fair and reasonable the commission shall consider whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply with health and safety regulations is improved, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable.

Section 820 of the Evidence Code states:

When relevant to the determination of the value of property, a witness may take into account as a basis for his opinion the value of the property or property interest being valued as indicated by the value of the land together with the cost of replacing or reproducing the existing improvements thereon, if the improvements enhance the value of the property or property interest for its highest and best use, less whatever depreciation or obsolescence the improvements have suffered.

Section 2720(b) provide the criteria for what, if any, portion of the purchase price over replacement cost less depreciation *of the distribution system* should be included in the rate base for ratesetting purposes, including whether the transaction offers efficiencies or economies of scale to offset all or some of the

premium paid, and whether the premium price's effect on existing customers of Cal-Am and Hillview is fair and reasonable. [Emphasis supplied.]

Joint Applicants argue that "fair market value" is determined by the "willing seller-willing buyer" standard of CCP Section 1263.320 (a) and is equal to the total purchase price of \$7,470,459, a number that was arrived at as a result of arm's length bargaining between Cal-Am and Hillview's owners.

Cal Advocates argues that the correct standard for determining fair market value is the one set out in CCP Section 1263.320(b) and that the correct fair market value is \$6,500,000, the equity purchase price.

The Hillview transaction is structured as a purchase by Cal-Am of all the issued and outstanding common shares of Hillview. In short, Cal-Am is buying both sides of Hillview's balance sheet rather than purchasing just the assets that constitute the distribution system. The basic principle of financial accounting is that balance sheets must balance, that is, Assets must equal Liabilities plus Shareholder's Equity. The parties have agreed on an equity purchase price of \$6,500,000, representing a premium of \$5,430,463 over the net book value of Hillview's equity, plus additional costs associated with the purchase of \$970,459, for a total agreed purchase price of \$7,470,459. Since Hillview's Liabilities will remain unchanged by the purchase, Shareholder's Equity will increase by the sum of the equity premium (\$5,430,463) and the additional costs (\$970,459) and — because a balance sheet must balance — Hillview's assets will increase by an equivalent amount. Upon closing, the enlarged assets and shareholder's equity, together with existing liabilities of Hillview, will become part of the balance sheet of Cal-Am, the acquiring corporation. For this reason, Joint Applicants argue that (a) the entire \$970,459 increase in the purchase price between the original application and the amended application represents

legitimate costs associated with the purchase and (b) the entire \$970,459 increase should be added to Cal-Am's rate base when the purchase is complete.

Cal Advocates does not question the reasonableness of the additional costs but argues that they should not be included in Cal-Am's rate base following closing of the purchase, as they are in addition to the value of the equity (\$6,500,000) on which the parties had already agreed.

### **3.2. Determination of Rate Base**

How much of the purchase price of \$7,470,459 should be included in Cal-Am's rate base following the acquisition of Hillview? As noted in the prior section, Cal Advocates argues that the originally agreed equity purchase price of \$6.5 million represents the fair market value of the distribution system that Cal-Am is acquiring, while the \$970,459 represents other costs associated with the purchase of Hillview's common stock that are not included in the value of the distribution system. We concur with this analysis and accordingly we conclude that (a) the fair market value of Hillview is equal to the total purchase price of \$7,470,459; and (b) upon closing of the transaction, Cal-Am shall increase its rate base by the equity purchase price of \$6.5 million.

With regard to accounting for the additional costs of \$970,459, we note that Cal-Am has complied with D.99-10-064 Appendix D Section 2.05 by setting forth in the Application an asserted Replacement Cost New Less Depreciation (RCNLD) of \$39,317,366 appraisal value for the Hillview distribution system<sup>1</sup> while Cal Advocates has proposed an RCNLD appraisal of \$21,707,580.<sup>2</sup> Since even Cal Advocates' appraisal substantially exceeds the total purchase price, the

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<sup>1</sup> Exhibit CAW-8; Owens Direct, at 7, Q&A 10.

<sup>2</sup> Exhibit Cal-PA 9; Report at 24.



additional costs of \$970,459 are presumptively reasonable and Cal-Am should be allowed to recover them over time.

### **3.3. Treatment of Tax Liability; Amortization Schedule**

The increase in the value of Shareholder's Equity resulting from the purchase creates an income tax liability for Cal-Am that is reflected in a proposed Allowance for Deferred Income Taxes (ADIT) of \$2,014,575.<sup>3</sup> As with the additional costs of \$970,459, Cal-Am may recover the ADIT over time but may not earn additional return on it. We will approve a 40-year amortization schedule for the additional costs and for the ADIT, the same amortization schedule we recently approved in D.19-04-015, in connection with Cal-Am's acquisition of the Rio Plaza water system.

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<sup>3</sup> Hillview already has \$403,133 ADIT on its books, representing a liability resulting from a difference between book and tax accounting. This amount will be assumed by Cal-Am when it steps into Hillview's shoes following closing of the Transaction.



### **3.4. Other Issues**

#### **3.4.1. Forrester Consulting Agreement**

The Application requests approval of a contract between Cal-Am and Mr. Roger Forrester,<sup>4</sup> currently Hillview's President, pursuant to which Mr. Forrester would act as a consultant to Cal-Am for a period of one year for a consulting fee of \$250,000, which cost would be recoverable from the ratepayers of Cal-Am. Mr. Forrester, a Grade 3 Water Treatment Operator, has been the operations manager of Hillview Water Company since 1981. In that capacity he has become familiar with all aspects of the company's operations. Cal-Am seeks to employ Mr. Forrester to take advantage of his detailed knowledge of the Hillview distribution system and his personal relationships with city and country officials, public works staff and other important groups and individuals involved in the operations of Hillview Water Company. The proposed agreement is for one year following completion of the acquisition of Hillview by Cal-Am.

Cal Advocates objects to charging the consulting fee to ratepayers on various grounds including its open-ended nature and the lack of competition for a consultant.

Notwithstanding those objections, it appears that Forrester is uniquely qualified to assist Cal-Am in the process of assuming management control of Hillview. We will approve the consulting agreement with the caveat that any costs beyond the basic fee of \$250,000 and the costs of any extension of the agreement will be borne by Cal-Am shareholders.

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<sup>4</sup> See Application at 2 and Exhibit 2 to Attachment 1 to the Application.

### 3.4.2. Cal-Am Request for Memorandum Accounts

Cal-Am seeks authority to establish a transactional memorandum account to track legal, engineering, surveying, appraisal, and Mr. Forrester's consulting expenses.<sup>5</sup> It also seeks authority to establish a contingency memorandum account to track amortization of the acquisition premium, including the gross-up in ADIT over a 40 year period and its authorized cost of capital applied to the Commission-approved post-acquisition rate base less the pre-acquisition return on rate base.<sup>6</sup> Finally, Cal-Am seeks authority to expand the currently authorized Memorandum Account entitled "Memorandum Account for Environmental Improvements and Compliance Issues for Acquisitions" and to allow the same costs as may be required in the Hillview acquisition as were allowed in the already approved account as related to the acquisitions of service areas in Dunnigan, Geyserville, Meadowbrook, and Rio Plaza. Cal Advocates objects to establishing the first two proposed memorandum accounts and does not object to expanding the third, subject to the proviso that the account exclude funds authorized in Advice Letter 113.<sup>7</sup>

Memorandum accounts are established pursuant to Commission Standard Practice U-27-W<sup>8</sup> which enumerates five requirements for the creation of a memorandum account. The first requirement is that the expense to be tracked in the account is caused by an event of an exceptional nature that is beyond the utility's control. An earthquake that damaged utility property would be an

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<sup>5</sup> Amended Application at 12 and Transcript, Volume 1 at 100: (Cal-Am/Owens).

<sup>6</sup> Exhibit CAW-10 at 14:1 and Transcript Volum1 at 102: (Cal-Am/Owens).

<sup>7</sup> Exhibit CAW-10, Owens Rebuttal, at 22, Q&A 38.

<sup>8</sup> Commission Standard Practice U-27-W, available at <http://docs.cpuc.ca.gov/published/REPORT/84069.htm>

example of such an event. In this case, the sole event that triggers the enumerated expenses in both requested new memorandum accounts is Cal-Am's decision to purchase Hillview, an event that is neither exceptional nor beyond Cal-Am's control. Although Cal-Am argues that the delays in processing the application are events beyond its control sufficient to meet the requirement of the Standard Practice,<sup>9</sup> a look at the procedural history of this application suggests otherwise. For example, had Cal-Am not chosen to submit a revised application seeking to add nearly a million dollars in additional costs to its rate base following its acquisition of Hillview, this proceeding would have concluded months ago.<sup>10</sup> Since Cal-Am fails to meet the first of 5 necessary requirements, we need not consider whether it meets any of the others. The requests to establish the transactional and contingency memorandum accounts will be denied. The request to expand the existing environmental memorandum account will be granted.

### **3.4.3. Rental of Office and Yard**

Hillview currently rents an office and the yard on which it is located from Forrester on a lease which has 15 years to run.<sup>11</sup> As part of the purchase Cal-Am will succeed Hillview as lessee under the lease. The lease rental payments are already built into Cal-Am's approved rates. Cal Advocates proposes that the lease should be reviewed as part of Cal-Am's next general rate case. But this is not an option. By purchasing the stock of Hillview, Cal-Am will stand in the shoes of Hillview so far as the lease is concerned and be subject to all its

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<sup>9</sup> Joint Applicants Opening Brief, at 39.

<sup>10</sup> Cal-PA accepted both the original \$6.5 million purchase price and its addition to Cal-Am's post-transaction rate base.

<sup>11</sup> Transcript volume 1 at l22, lines 14-17; (Cal-Am/Owens).

provisions, specifically including the 15-year remaining term and the rent stated in the lease. Any unilateral alteration of the lease, whether in the context of a general rate case or otherwise, would be a breach of its terms and entitle Forrester to seek damages.

#### **4. Cancellation of Hillview's Certificate of Public Convenience and Necessity (CPCN)**

Upon completion of the acquisition Hillview will cease to exist and Cal-Am will assume its CPCN.<sup>12</sup> To avoid confusion following closing of the Transaction, we will cancel Hillview's CPCN and expand Cal-Am's CPCN to include the Hillview service territory.

#### **5. Comments on Proposed Decision**

The proposed decision of Administrative Law Judge (ALJ) Karl J. Bemesderfer in this matter was mailed to the parties in accordance with Section 311 of the Pub. Util. Code and comments were allowed under Rule 14.3. Filed comments on \_\_\_\_\_, and \_\_\_\_\_ filed reply comments on \_\_\_\_\_.

#### **6. Assignment of Proceeding**

Liane Randolph is the assigned Commissioner and Karl J. Bemesderfer is the assigned ALJ in this proceeding.

#### **Findings of Fact**

1. The total purchase price of Hillview is \$7,470,459.
2. The fair market value of the equity of Hillview is \$6,500,000, which includes an equity premium of \$5,430,463.
3. The total purchase price of Hillview is less than the Replacement Cost New Less Depreciation of its distribution system.

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<sup>12</sup> Transcript volume 1 at 44 (Cal-Am/Forrester).

4. Cal-Am will incur a federal income tax liability of \$2,014,575 as a result of purchasing Hillview Water Company, Inc.

5. Upon completion of the purchase Cal-Am will become the lessee under the existing lease from Roger Forrester and will acquire Hillview's CPCN.

6. Cal-Am has failed to meet the requirements of Commission Standard Practice U-27-W for establishing new memorandum accounts.

**Conclusions of Law**

1. \$6,500,000 of the total purchase price should be added to the rate base of Cal-Am.

2. \$970,459 of the total purchase price should be amortized over a period of 40 years.

3. Cal-Am should establish an Account for Deferred Income Taxes in the amount of \$2,014,575.

4. The Account for Deferred Income Taxes should be amortized over 40 years.

5. Cal-Am's request to establish new memorandum accounts should be denied.

6. Cal-Am's request to extend an existing memorandum account should be granted.

**O R D E R**

**IT IS ORDERED** that:

1. The application of California-American Water Company for authority to purchase Hillview Water Company, Inc. is granted subject to the conditions herein.
2. Upon closing of the purchase, California-American Water company shall (a) increase its rate base by \$6,500,000; (b) amortize \$974,459 of the total purchase price over a period of 40 years; (c) create an Account for Deferred Income Taxes in the amount of \$2,014,575; and (d) amortize the Account for Deferred Income Taxes over a period of 40 years.
3. Hillview Water Company Inc.'s Certificate of Public Convenience and Necessity is cancelled.
4. California-American Water Company's Certificate of Public Convenience and Necessity is enlarged to include the service territory of Hillview Water Company, Inc.
5. Expansion of "Memorandum Account for Environmental Improvements and Compliance Issues for Acquisitions" to allow the same costs as may be required in the Hillview acquisition as were allowed in the already approved account as related to the acquisitions of service areas in Dunnigan, Geyserville, Meadowbrook, and Rio Plaza is approved, subject to the proviso that the account exclude funds authorized in Advice Letter 113.
6. All dollar amounts set forth herein shall be adjusted as of the date of closing of the purchase of Hillview Water Company, Inc.
7. Application 18-04-025 is closed.

This order is effective today.

Dated \_\_\_\_\_, at Los Angeles, California.